Banking's Final Exam
by Morris Goldstein

Discussion by Giovanni Dell'Ariccia (IMF and CEPR)

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Summary

- Comprehensive, interesting, timely book

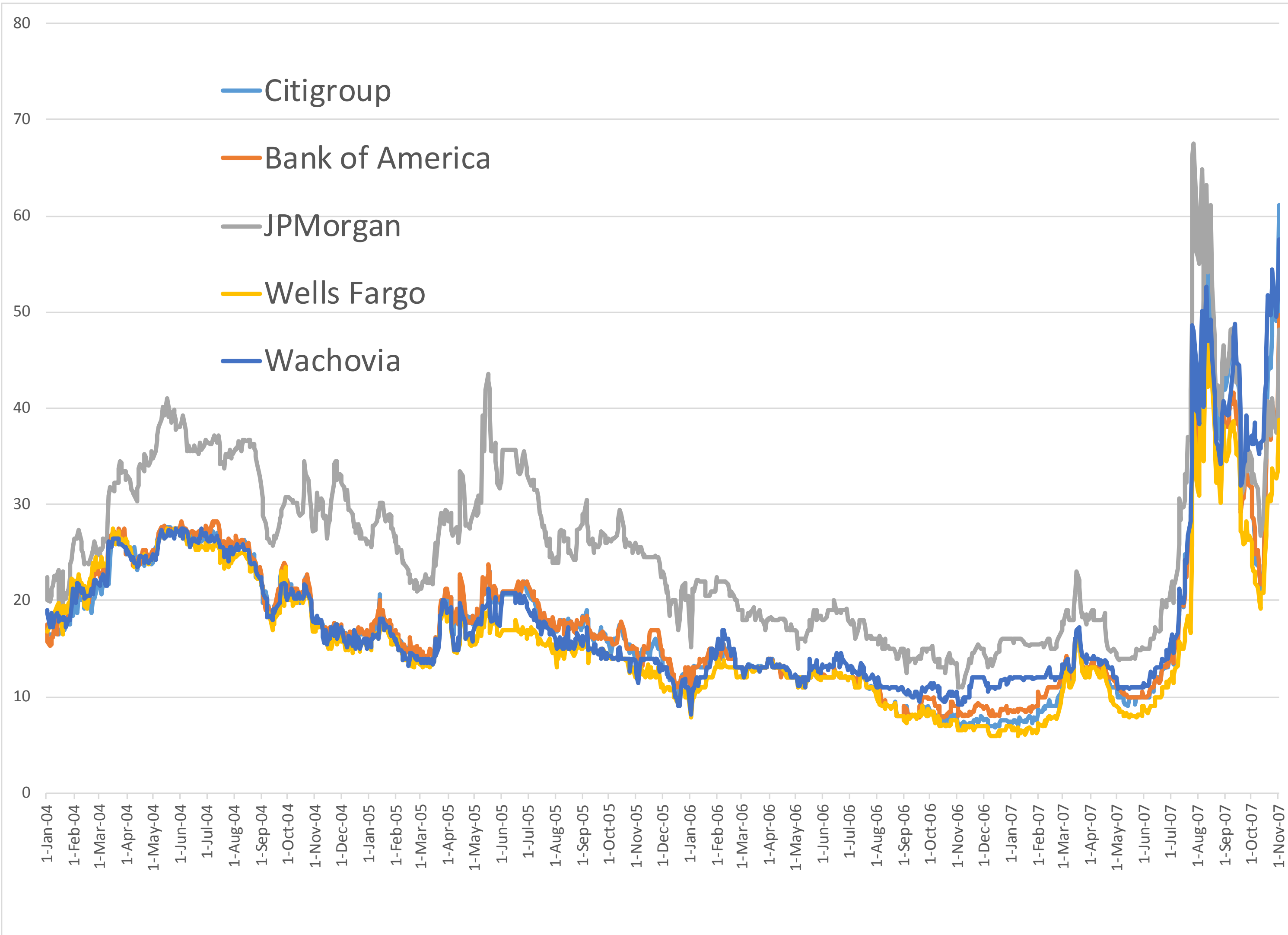
- Agree with many of its main conclusions
  - More capital/Potential issues with TLAC
  - Greater use of leverage ratio
  - Many of the things said about stress tests

- Yet, doing my job. A few critical remarks

Optimal Capital

- Should capital be sufficient to avoid the need for all forms of policy response?
  - Morris rightly sets this question as one of credibility of current framework
  - Tradeoff between MH associated with bailouts and spillovers associated with bail-ins
- MH as risk-shifting and/or higher leverage (stronger evidence)
  - Higher capital improves tradeoff on both fronts

Bank CDS spreads before GFC



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- MH as risk-shifting and/or higher leverage (stronger evidence)
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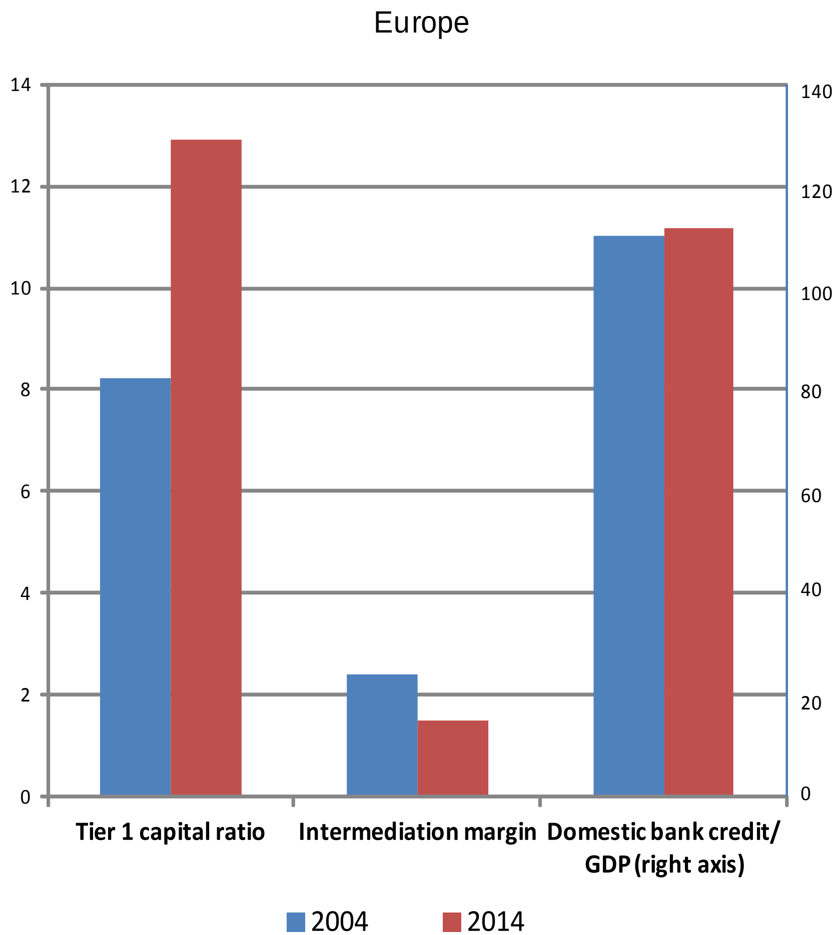
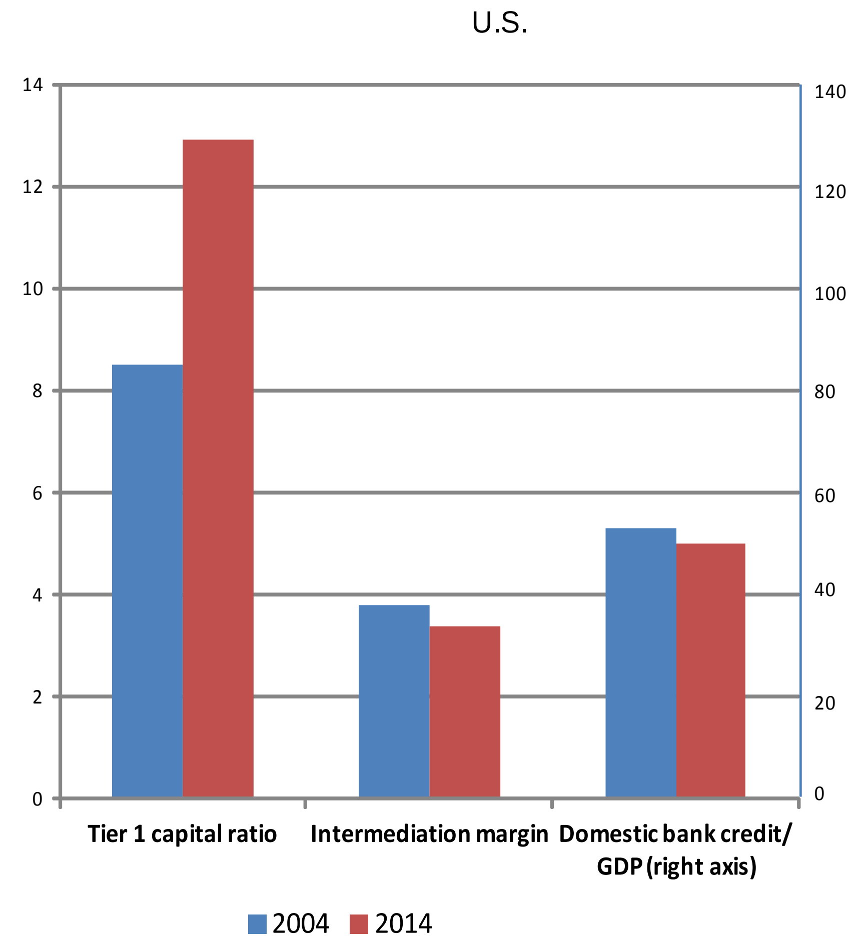
- Higher capital (and arguably TLAC) reduces spillovers

- Evidence on costs inconclusive, yet…

Much Higher Capital…Similar Aggregate Credit



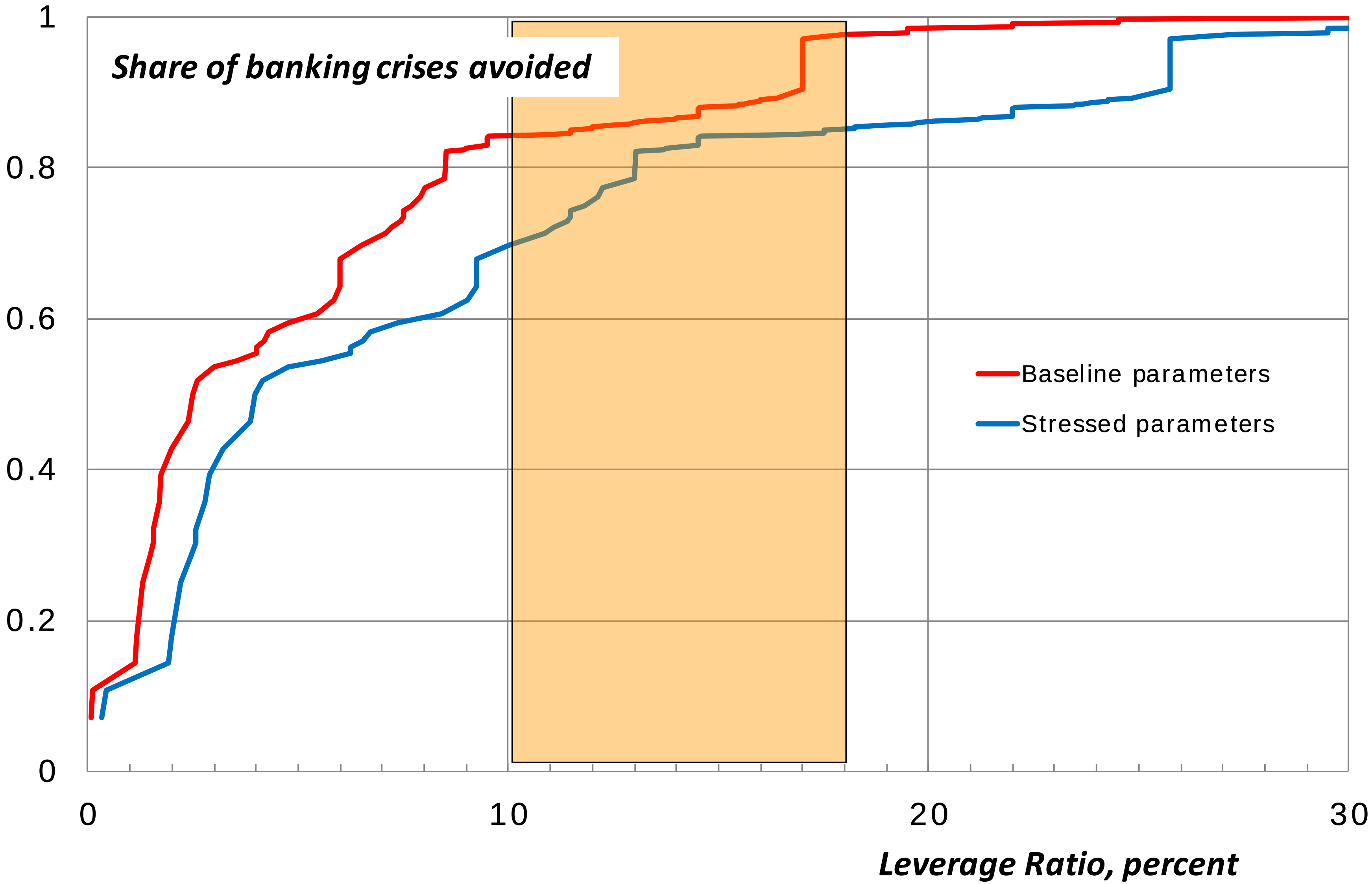


Notes: Averages for banks - U.S. and European G-SIBs (U.S.: (Bank of America, Citigroup, JPMorgan Chase, Wells Fargo; Europe: Barclays, HSBC, Royal Bank of Scotland, BNP Paribas, Credit Agricole, Societe Generale, Deutsche Bank, and Credit Suisse). Domestic bank credit/GDP for Europe is weighted average for France, Germany, UK.

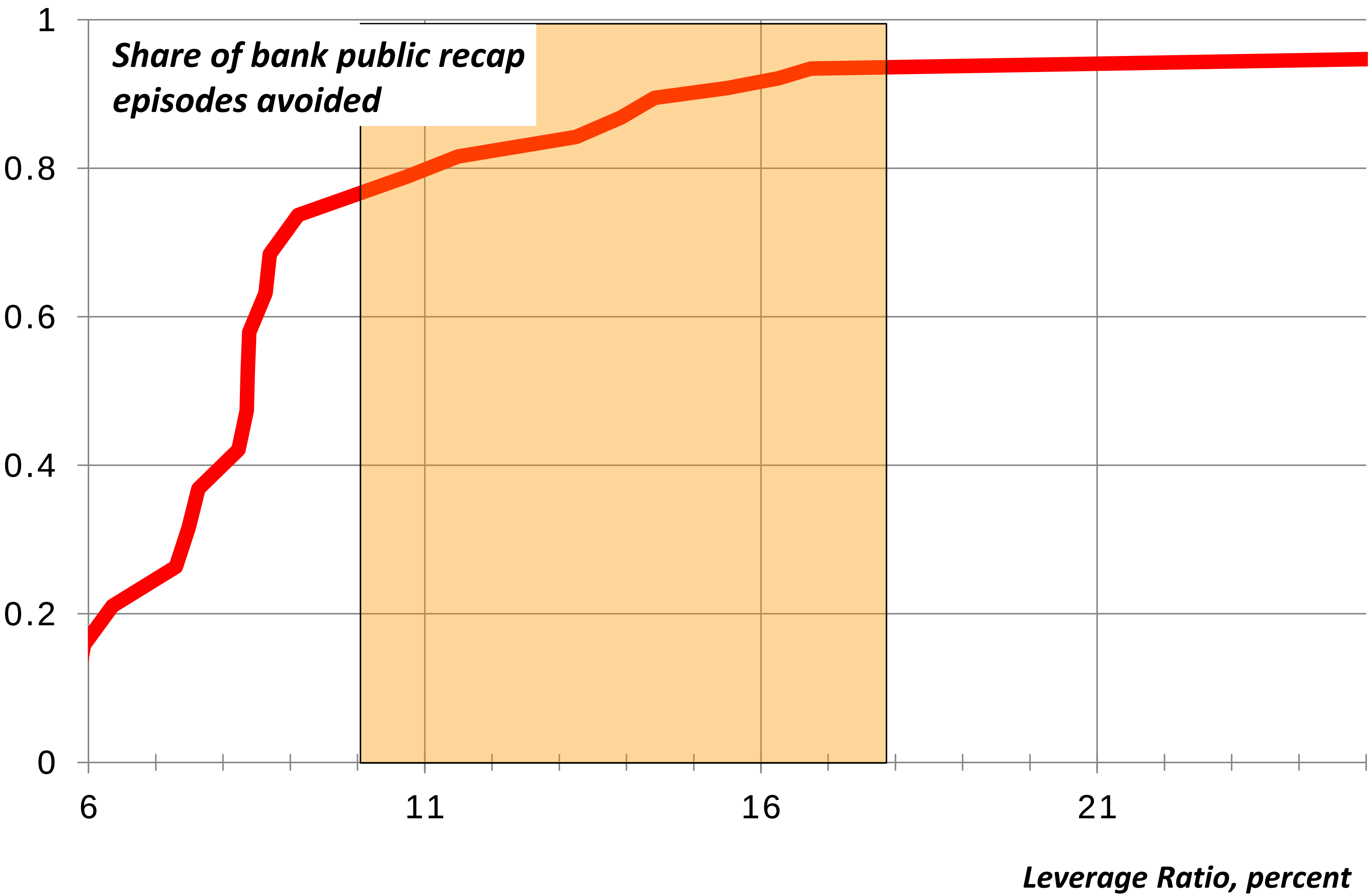
Proposed Leverage Level against Past Crises?

- The leverage ratios proposed in the book would have avoided most banking crises in OECD countries

Seawall approach (based on past OECD NPLs)



Seawall approach (based on OECD past recaps)



Proposed Leverage Level against past crises?

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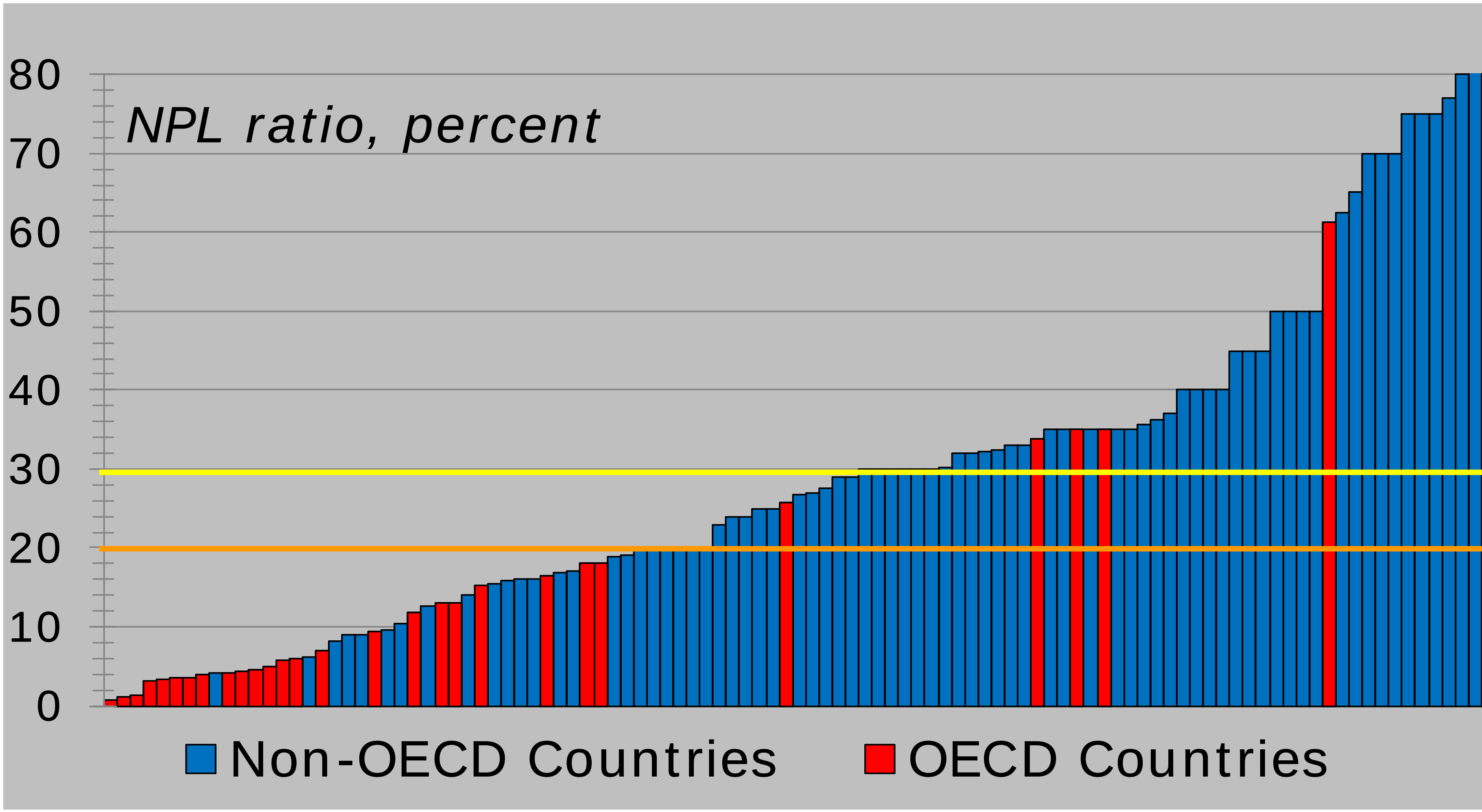
- What about emerging markets?
  - Larger shocks
  - Lower recovery rates
  - Silver lining: banking systems are smaller, so losses in percent of GDP more easily contained

NPLs and Loss Absorption in Past Crises



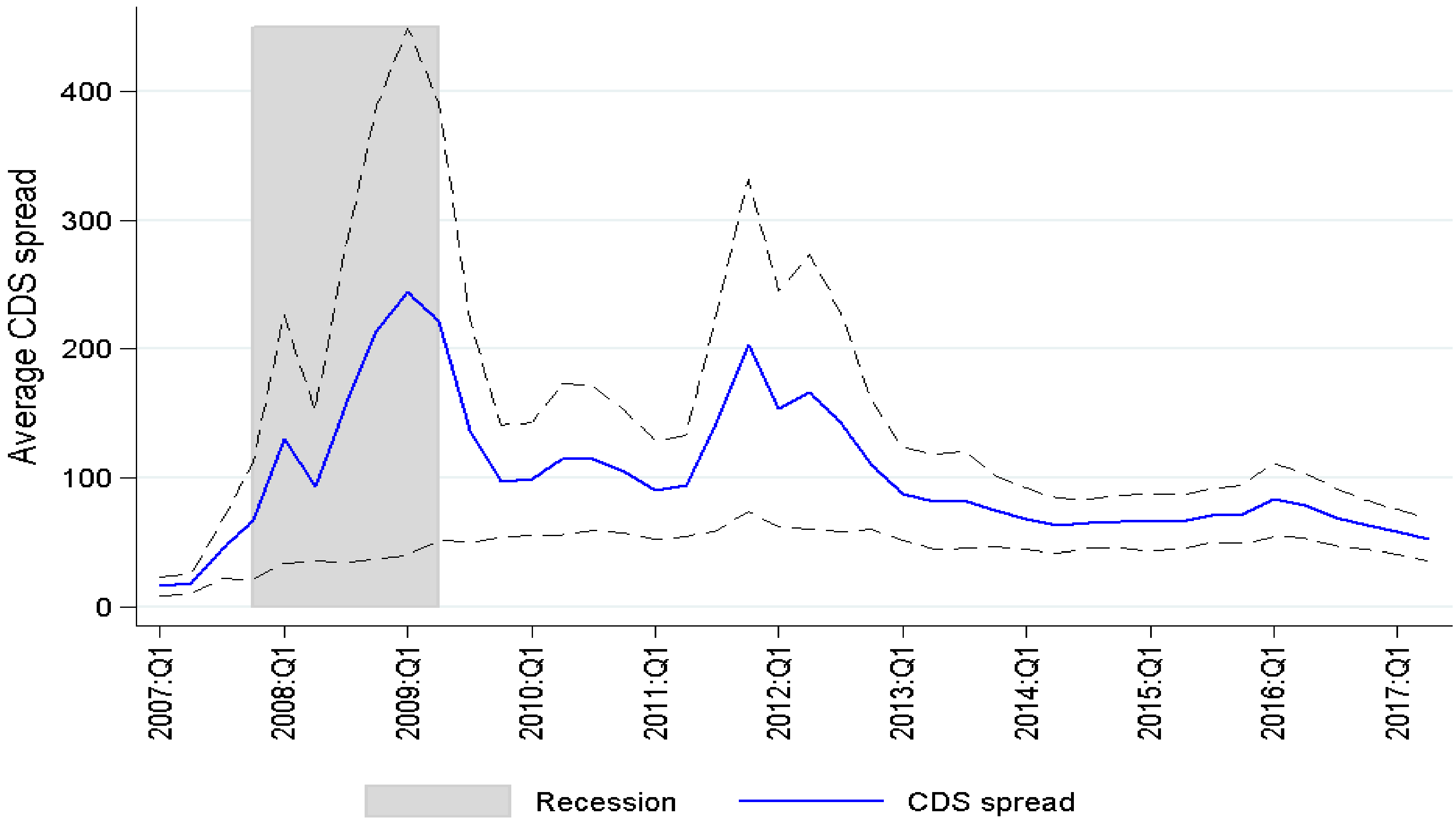
Source: Dagher at al., 2016

Risk Surcharge

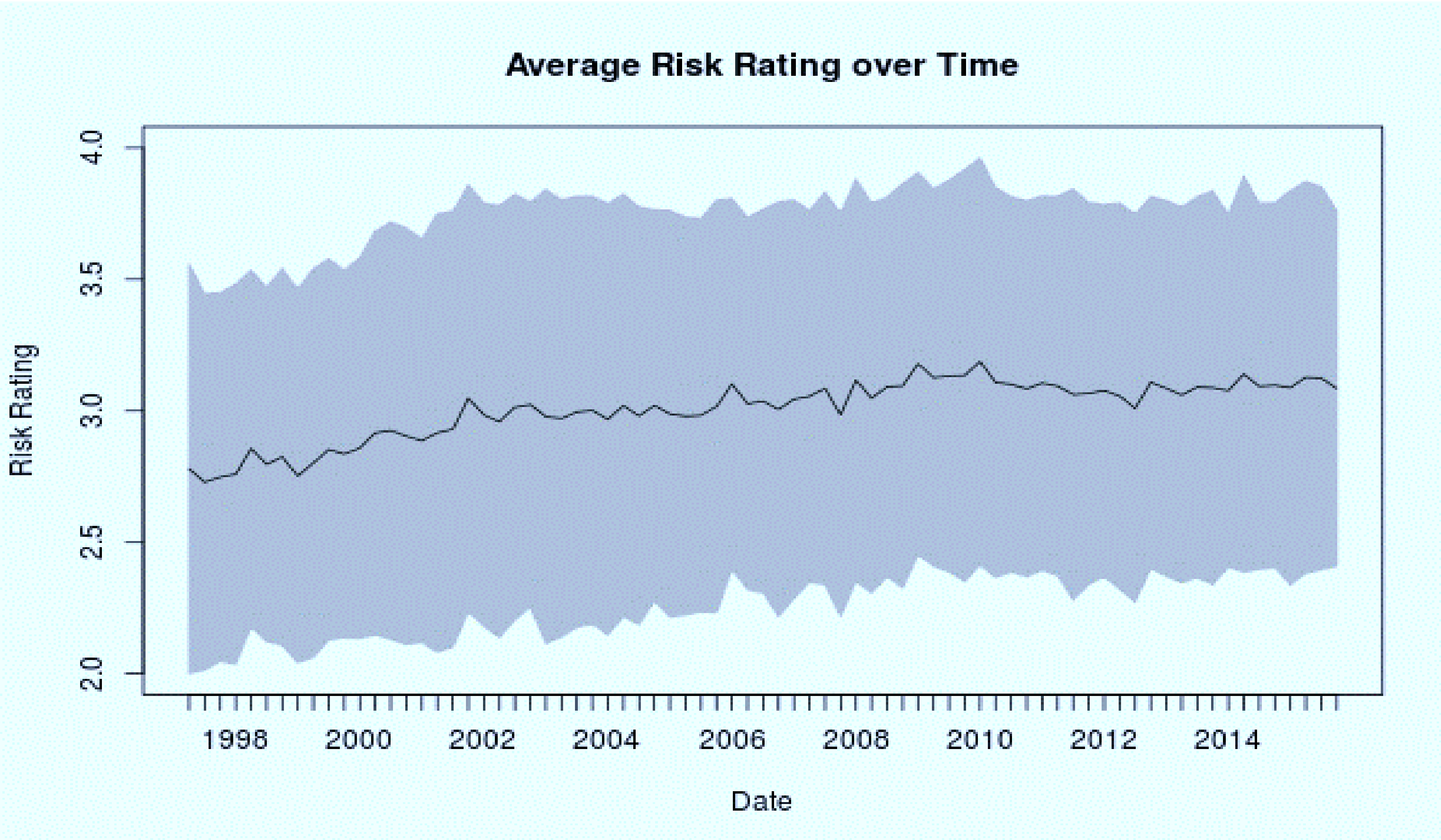
- Political economy of time-varying regulatory requirements tricky
  - Nobody sees the crisis that did not happen

- Yardstick approach may prove challenging
  - “as long as the music is playing…”
  - Is cross-sectional heterogeneity sufficient in tranquil times?

Bank CDS Spreads



Riskiness of newly extended loans



Source: Dell'Ariccia, Laeven, and Suarez, 2017